



The Main Problems and Directions of City-Company Restructuring in Belarus

Summary

Transition from planned to market economy implies changes to the principles of management and to the relative responsibilities of state and enterprises. The state should provide the economic actors with general “rules of the game” and most social functions. Enterprises, having economic freedom, can then aim to maximize sales and/or profits. The process of enterprises adjusting to this new economic environment is called restructuring. In general it means that a post socialist enterprise needs to update equipment, improve technology, reshape its organization and management, find new markets and reduce excessive staff. All of these measures require money and knowledge. And as the experience of other CEE countries shows, in many cases the best way to bring out restructuring is privatization and attracting foreign investments. But an appropriate institutional framework must be implemented before foreign investment can be attracted. In the case of Belarus, however, we notice that a policy of soft budget constraints is still being practiced, where, the bigger an enterprise is, the more government support it can acquire. Moreover, the existing privatization legislation and the investment climate in general are in need of improvement.

Belarus inherited many city-companies from the Soviet production structure. The majority of these enterprises are loss making or of low profitability, like the majority of all enterprises in Belarus. They have numerous economic problems: poor production assets; lack of investment and innovation; and hence, low production competitiveness; labor and assets overcapacity. They badly need restructuring since their economic problems create social tensions in their cities (closing any such enterprise could result in 25% and more unemployment in the city).

Belarus can learn from the experience of other CEE countries and try not to repeat their mistakes. Hence, this Policy paper takes a look at the experiences of other CEE countries concerning restructuring. The experiences show us that cost transparency, the identification of core businesses, independent assets evaluation, and a general market institutional environment with stable and transparent “rules of the game” must apply in all cases. This paper also lists possible main directions for implementing city-company restructuring in Belarus. Among the most urgent we note the need to liberalize current economic policy, which would improve the investment climate; enacting amendments to the laws “About privatization” and “About bankruptcy”; encouraging the independent evaluation of assets; separating of productive from non-productive assets; supporting and promoting SME development; and deregulating the national labor market.

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1. Introduction

There are about 170 city-companies in Belarus, employing approximately 10% of the active labor force. In most cases these enterprises have so far failed to restructure and to diversify their production. As the experience in neighboring countries shows, liquidating a city-company means not only enormous unemployment (usually more than 25%) in the city, it will also influence the overall purchasing power in the city and its surrounding area, and will reduce the revenues and profits of other local enterprises. Therefore, because of its economic importance, the collapse of a city-company automatically implies the disintegration of major economic structures, with large-scale social and political fallout for the entire region.

Currently the government provides the majority of city-companies with different forms of subsidies¹. But the state cannot afford these preferences and subsidies in the long run. Moreover, these subsidies burden the rest of the economy, lowering standards of living and destroying jobs elsewhere. Besides, numerous cases of property rights violations and state over-regulation do not facilitate changing the negative investment climate in Belarus. Therefore, the opportunity costs for the population and the enterprises are increasing every day. That is why the current industrial policy should be changed and alternative means of restructuring must be found.

In order to provide the reader with our approach to solving the problem of city-company restructuring, this Policy Paper is structured as follows: In the second section we define city companies and the problems they face in Belarus. The third section is devoted to the international experience of dealing with these problems. The fourth section includes general prerequisites, possible directions and mechanisms for restructuring city-companies in Belarus. And the last section provides conclusions and policy recommendations.²

2. The situation with city-companies in Belarus

Almost all countries of the former Soviet Union had to face the problem of cities with one major employer and narrow specialization. They are a consequence of the centrally planned economy of the USSR integrating vast specialized production facilities which were spread all over the country. Economic efficiency was not the main factor of resource allocation, the expected benefits of economies of scale were tremendously overrated. Especially Belarus was designed like an "assembly line" within the Soviet Union, which means that many plants and factories (as a rule in the military and machinery sector) were designed to be parts of other, bigger plants situated elsewhere in the Soviet Union in order to tie the various republics into one mechanism.

How can a city-company be characterized? According to the definition in the Law "About bankruptcy" a city-company is one that employs 25% and more of the labor force (economically active people) in a given city (town). How many such companies are there in Belarus? At present it is quite difficult to answer this question due to data problems. Based on the list from the Supreme Business Court there are approximately 170 city-companies with more than 1000 workers in Belarus. Among 212 cities and towns in Belarus, 171 have a population of less than 20000. And most of these cities and towns depend on the operation of one or two major plants: city-companies. Most of them are in the glass, chemical, electronic, light, extractive and machine building industries.

Since 1995 the situation of Belarusian city-companies has dramatically worsened. The financial status of the majority of them is devastating. The difficult financial status of these enterprises makes it almost impossible for them to invest in innovation programs, to cut production costs, to increase the competitiveness of their products and to develop new ones. Moreover, due to overcapacity, the production costs of most city-companies are very high. This overcapacity has two aspects: redundant industrial assets with plenty of non-industrial facilities and exces-

¹ According to a survey conducted by the IPM, 75% of all industrial enterprises receive different forms of government preferences. More detailed information about this survey and its results can be found on the IPM web-site: <http://research.by/>.

According to data of the State Control Committee, 2000 enterprises received individual benefits in 2003 (in 2002 – "only" 208 enterprises). The financial support provided to enterprises by the Ministry of industry amounted to more than half of all the taxes paid by the enterprises of this ministry.

² In this Paper we concentrate on the major but general problems of restructuring. More specific topics concerning city-company restructuring, as for example unemployment policy, are not the subject of this Policy paper.

sive employment. Most of the city-companies were built during Soviet times in order to supply the Soviet production plan. Today few of them produce or sell more than 30% of their former production capacities. Furthermore, city-companies carry the burden of supporting social infrastructure; hence their costs are excessively high (even if they do not pay taxes). In addition, due to the Soviet inheritance that there be no unemployment, most of these enterprises suffer from an excessive workforce. The existing labor legislation makes it difficult for an enterprise to lay off excess labor. Sometimes it is cheaper for this enterprise to pay employees wages – these can be quite small since enterprises might work for just a few days a week – than to lay them off and pay all the lay-off allowances that would become due as a result. Also, there is an informal ban on mass dismissal for reasons of social stability in the country.

To date the majority of industrial enterprises have not implemented any active restructuring. That is why we are not able to provide any case study or an example of successful restructuring. An unclear and unsustainable institutional environment does not allow them to change their organizational structures, to attract foreign investors and to become independent of the state. Enterprises change what is easy to change. For example, one of the ways of passive restructuring is a slow reduction in employment. The analysis of the micro data of the Ministry of Economy shows that during the last 10 years most of the enterprises reduced employment by 30-40%. This is confirmed by IPM survey data. According to it on 1 Jan. 1991 the average industrial enterprise had 2310 people, on 1 Jan. 2002 – 1475, on 1 Jan. 2003 – 1349 people. Yet the problem of redundant employment remains important for most enterprises³.

Although this problem is of great importance, a comprehensive state program or approach to restructuring city-companies is lacking. Worth mentioning is a recent joint UNDP / Ministry of Labor project⁴. Conducted by experts and specialists, this analysis shows that simply mechanically reducing an excessive workforce will not solve the problems for a city-company or for the city in which it is located. It will only exacerbate tensions on the local labor market and increase the number of people who require state support. Therefore, the authors of that project come to the conclusion that it is necessary to implement socially responsible restructuring i.e. to choose the optimal variant of reallocating the economically active workforce: the problems of the city-company, its employees and the town have to be solved comprehensively by all the people who have an interest in it.

Many Belarusian enterprises are in need of bankruptcy procedures. However, the existing law "On bankruptcy" includes many limitations on the process of sanitation and bankruptcy for city-companies. For example, the state can decide that the term of sanitation should be prolonged for 10 years. If enterprises are sold at an auction, the buyer has to keep at least 70% of the enterprise's current work force. In case the enterprise changes its main production profile, the buyer should ensure retraining redundant employees at his own expense or he should employ at least 70% of those employed on the date of buying the enterprise. Moreover, the most recent changes in this law have made privatization of a city-company via the mechanism of bankruptcy a very complicated procedure.⁵ This situation has been compounded by the decree on the "golden share".⁶

Thus, important preconditions for a promising restructuring of city-companies have not been met. Under current conditions in Belarus, potential private investors do not have a free hand to carry out internal restructuring. Only a market economy based on private ownership provides the incentives, which can lead to improved enterprise performance.

3. The relevance of enterprise restructuring and lessons from Eastern European experience

Belarus is not the first country, which faces the necessity of enterprise restructuring. How did other countries deal with this task? What are the main lessons to be learned from transformation within other CEE countries and East Germany? They are: First, the state must create a

³ If roughly 500.000 persons work in such enterprises and 30% of them are redundant, restructuring could lead to as many as 150.000 people in need of unemployment benefits, retraining etc.

⁴ Its pilot project was the situation of the glass plant "Neman" in the town Berezovka (district of Lida), which employed 70% of the town's population. The analysis showed that the labor market could absorb not more than 400 workers, whereas the plant would have to lay off 1000. The share of redundant workers in this plant rose from 2.1% in 2000 to 24.3% in 2002.

⁵ See edict on 12.11.2003 No 508 "On some issues of enterprises insolvency (bankruptcy).

⁶ See edict on 01.03.2004 No 125 "On the special right of the state to manage economic entities ("golden share)".

market economy framework, in which enterprises can assume their own responsibilities and solve their own problems. Second, the earlier this framework exists, the faster the transformation process will generate benefits for all participants. Third, in most cases restructuring is impossible without privatization. As a rule, state enterprises are unable to implement and manage the process of deep restructuring. *10 years of privatization in the CEE countries have taught the following lessons:*

1. The most successful form of privatization is the money-sale of an enterprise to a strategic investor. An investor with money, know-how, technology, access to markets and distribution channels has the best prospect for making an enterprise profitable⁷.
2. The best results in selling small plants can be expected in open, transparent auctions in which all interested groups are able to participate. But in the case of selling big enterprises the better solution might be an investment contest.
3. Privatization to small owners (voucher holders, employees) can hold certain risks: Enterprises in NIS countries that were privatized by such schemes have often suffered from a lack of quality corporate management, limited financial credit, weak protection of minor stockholders' rights, insufficient protection from insider deals, etc.
4. Privatization has demonstrated the low quality of the activities and property management formerly provided by state bodies. Money privatization has led to a decrease in corruption and abuse of budget resources, and attracted competent managers unwilling to work for the state.
5. Privatization encourages the development of the stock market and attracts new investments; market prices for commodities, resources and land enhance the efficiency of economic decisions.
6. Implementation of privatization under unclear conditions, without transparent open legislation, leads to negative public opinion and a desire to revise its results. This limits the number of potential investors and increases their risks.

Based on the lessons from the experience of other CEE countries and East German, we can formulate some goals, which the state should pursue to speed up and improve the restructuring process:

1. *Achieving cost transparency.* A critical precondition for a successful restructuring process is comprehensive and precise knowledge of the production costs of each unit of an enterprise. This also includes a realistic, market-based valuation of a company's assets and capacities. Here, one should take into account that it is difficult if not impossible to determine the net value of a company during the transformation process. In most cases, the net value of the fixed assets of a company deteriorates dramatically during transformation since the "hardware" no longer suits the overall framework conditions. When assessing the net value of a company's fixed assets, it is important to recognize that the predominant methods for the evaluation of the capital value (net present value analysis) and the substantive value (net asset valuation method, property valuation method) are only applicable to a limited extent. It is impossible to quantify various critical elements under the specific circumstances of a reconstruction process. Numbers will necessarily remain incomplete.
2. *Identification of core businesses.* The precise and proper definition of core business areas and separable performance units is crucial for the further successful development and implementation of the modernization and restructuring process. In addition, it is also worthwhile to consider the relevance of cross-sectional performance units. As well it is essential to recognize the necessity of building new corporate structures to advance the modernization process.
3. *Determination of the actual level of risk.* The activities described above provide a first informed impression of the level of economic risk and exposure a company faces. For example, a cost ratio system allows management to determine whether a company is over-indebted. In such a case it is essential to determine whether the short-term viability of the company can be

⁷ Social equity, economic efficiency, budget revenues and political stability are among main tasks of privatization. Nevertheless, the experience of CEE countries shows that only very few enterprises can be regarded as a significant source of budget revenues. Moreover, it proves that privatization can deal successfully with only one task and not many. For example, if you choose to increase economic efficiency of enterprise, you should not take fiscal, social, or political tasks into consideration.

ensured by further deconcentration, creditor negotiations, etc. The cost ratio will also show whether or not a company faces an imminent liquidity crisis. In that case it is essential to determine whether there are ways to bridge the liquidity crisis through short-term cash credits from banks or guarantees from the government.

Such an analysis may be painful for management and employees, as it is likely to reveal that the company's products have a low quality at a high price, that asset values have been overestimated, etc. However, it is a crucial precondition for the development of a successful restructuring concept.

Concentration on core business activities has to form the core of a rehabilitation master plan. Non-essential business activities are to be regrouped into new companies that could serve as suppliers for the core business. This way, the new companies are able to diversify their business activities and find other customers. A general restructuring concept should be developed before further (potentially irreversible) actions are taken. While it may be revised and updated as the process goes along, the main elements and goals need to be clearly spelled out from the start. Besides, a restructuring concept is also an indispensable tool for the constructive engagement of third parties (government, banks, creditors, potential investors, etc.) into the overall modernization and restructuring process.

4. Separation productive from non-productive assets. One of the key points in restructuring is the separation of the social sphere from the productive one. Social services have to be provided by the public sector or other para-public institutions. To clearly separate these social services from the privatized companies is an indispensable part of restructuring. However, such a clear division between the economic and social sectors does not necessarily preclude effective and innovative cooperation between a company and the city administration. There has to be a willingness to assume responsibility on both sides. Both are jointly responsible for creating the proper framework conditions for the development of an attractive and economically successful region. Attracting new investors and promoting the diversification of the local economy are two important ingredients of that process.

5. Modernization of core business facilities and infrastructure. In some cases, the modernization of core business facilities may have to be completed before privatization. Certain industrial sectors are highly dependent on the existence of a strong technical and logistical infrastructure to support their highly integrated and resource intensive production cycles (e.g., the chemical sector). This is not to say that such "utilities" cannot be privatized. Yet, experience shows that such companies only become interesting for potential investors in case of advanced investments. If a sector promises future growth potential, it may make sense for the government to subsidize an improvement in local infrastructure to facilitate and support the modernization of its economic structures. The same applies to those cases in which there is a strong degradation of the environment as a result of previous production practices. Repairing environmental damages is often a precondition for privatization, since private investors do not want to incur (possibly unexpected) costs of cleaning up. This might even result into lower overall investment costs, since the companies can then concentrate on their core competencies and need to invest less in non-essential services.

But the main lesson of the experiences of other CEE countries shows us that the earlier the state starts creating a market economy and begins the restructuring processes the faster transformation will start bring benefits to all groups. On the other hand, the longer it waits, the longer and deeper will be the inevitable decline.

4. Guidelines for restructuring city-companies

4.1. General prerequisites

In a market economy under internal and external influences the market mechanisms filter out the best enterprises, awarding them with consumer demand, profit and reputation, and punishing those who have taken the wrong decisions. Loss-making enterprises should find new, more effective owners or they would close in order not to waste resources. The market approach to restructuring, i.e. adjusting enterprises to the new conditions, means comprehensive reforms in enterprise operation, management and ownership that entail fundamental changes in the functions the state and the enterprises perform.

The investment climate in Belarus needs considerable improvement. Its negative image is reflected in various indices and reports of international organizations that monitor the situation (EBRD, IMF, WB, Freedom House, etc.). Belarus has received some of the worst rankings of progress in economic reform among the post socialist countries, and many of its rankings are deteriorating. For example, according to the estimation of the Institutional Investment Observer, Belarus is 135th out of 145 countries; ten years ago it was 98th. Therefore, in order to prepare the basis for the restructuring of city-companies, the state should implement some basic reforms concerning the state support and the over-regulation of the real sector.

Currently the Belarusian government keeps alive almost every enterprise, supporting inefficient production and channeling taxes from efficient enterprises to loss making ones. The result is an opaque and complicated system of subsidization and counterproductive incentives. Instead, the government should concentrate on providing appropriate framework conditions. The company itself will then make the most effective decisions concerning its business activities. The government should only manage and direct these processes by providing macroeconomic stability, secure property rights and the rule of law.

The existing legislation does not stimulate the process of financing restructuring and can hardly be used for the purpose of finding new owners for enterprises. However, the problems of city-companies have to be solved. Ignoring them today will increase the direct and indirect costs of future reforms and lead to intense social conflicts.

The process of restructuring city-companies should be based on the following principals:

1. Division of responsibilities, and separation of the social from the productive sphere;
2. An negotiation process between the government and investors;
3. Hard budget constraints which does not mean an end to all subsidies to enterprises. instead, the distribution of subsidies should be transparent and depend on how well restructuring is progressing;
4. Entrepreneurial freedom of the privatized enterprises to make their own decisions;
5. Allowing competition by admitting external investors and competitors (open markets).

As a starting point in the process of looking for solutions to the problems of city-companies we might consider two scenarios:

1. There is a low demand for goods of a city-company at present but there is reason to believe that the demand could reappear. In this case government assistance should be directed at keeping the enterprise afloat and supporting attempts to restructure it;
2. There is no demand for goods of the city-company at present and there is no reason to believe that one might develop in the future. Such an enterprises should be closed down. In this case the government should assist in helping the employees find new jobs and attracting new businesses to the region.

In addition to the government at least four other groups should be involved in solving the problems of city-companies: the owners/managers of the city-company, its work force, the local authorities and the population of the town. The process of restructuring should only be started if both the workforce and the management of the enterprise display an initiative to restructure and there is a realistic strategic plan for the restructuring. During the entire process the general population should be provided with all the relevant information about the process since it must have a major impact on the whole endeavor.

4.2. Possible directions and mechanisms of restructuring city-companies

At the enterprise level

Ensuring sustainable work for city-companies implies their restructuring. This should consist of activities aimed at improving the quality of its management who will carry out restructuring effort, working out a plan for restructuring the enterprises, and scheduling the actions that need to be implemented first. Restructuring city-companies should proceed along the following steps:

1. Identification of competent and proper auditor

Big enterprises should be audited by international experts, small ones could be evaluated by local but nonetheless independent experts. Potential investors will be interested in obtaining accurate assessments by professional auditors, and are willing to pay for this. The most important thing here is not how the external evaluation is financed but that it result in an independent assessment. State officials should not try to influence the results of these evaluations.

2. A realistic assessment of the enterprise's assets and a determination of its "core businesses"

The temptation for the state authorities to consider privatization as an additional source of revenue for the state very often leads to overestimating an enterprise's value. The problem is that, as a rule, the real state of the productive and non-productive assets of the enterprises does not correspond to their stated values in the balance sheets. Hence, the first step in restructuring is to provide city-companies with realistic valuations of their assets. The "core businesses" should be determined, since the more efficient decision may in the end be, not to save the enterprise as a unit but only its most profitable parts. Again, the independent auditors and accountants must aim at transparency in cost formation and finance flows (payments, cost structure, debts etc).

3. Separation of productive assets from non-productive ones

As noted above, city-companies are as a rule overloaded with social objects, which they have to finance. Yet, such "capital" cost amortization raises the general costs and sometimes makes enterprises loss making. An investor should not have to buy a city-company together with its social objects (greenhouses, culture houses, etc.). Such infrastructure objects might be turned over to the local authorities or – if they are profitable – sold to separate investors.

4. Privatization

The pace of privatization in Belarus is very slow. It is implemented like a formal corporatization while all assets and decision making remain under state control. As discussed in the IPM Policy Paper 3/03 continuation of the voucher privatization scheme would cause a lot of problems. The state as the main shareholder changes nothing in a privatized enterprise's function. Moreover, a state enterprise has more chances to get different kinds of state support. This could dramatically decrease the number of enterprises, which would want to be privatized in principle.

But the main step in the process of restructuring city-companies remains their privatization. Privatization can be tackled in a few steps. Unalterably insolvent enterprises should be sold first and quickly in an open and transparent contest. This might involve an auction, an agreement between creditors about property division, or the initiation of bankruptcy procedures. Some enterprises could be sold even for a symbolic price, if that attracts an investor. Doing so will create positive examples which together with other measures will change the investment image of Belarus. These enterprises should be privatized within the first 1 to 1.5 years. Simultaneously, yet possibly taking more time for evaluation, etc., the process of privatizing enterprises with up to 5000 employees should commence. As a final step the government should work on the privatization of big, strategically important enterprises through negotiations. The main issues for negotiations between a possible strategic investor and the government are likely to be the number of people to be laid off, the volume of investments and the volume of possible subsidies. A final price for the city-company must be defined by taking all of these factors into consideration.

New economic policy and SME promotion

At this moment the government of Belarus still continues to follow an industrial policy that has proven to be inefficient. Soft budget constraints and attempts to keep all enterprises (mostly state owned) alive, without providing their managers with the freedom to make economic decisions, has created a system of distorted incentives. For this reason, the restructuring of city-companies also requires deregulation.

Due to the poor financial situation of most city-companies and their inability to operate efficiently, the challenge is not to improve their performance but rather to keep some of their parts in good shape so that they can exist and work as independent units. They could also be turned into small enterprises and become new employment centers with potential for growth and development. Joint efforts by the national and local authorities should be directed at creat-

ing a network of small and medium-sized firms (SME) – and this not only part of the restructuring efforts of city-companies.

Also, attracting new companies is necessary for the successful completion of the restructuring process. Even if a city-company is successfully restructured, it is highly unlikely that the newly created companies will offer the same number of jobs to the local workforce. Unemployment is a notorious feature of every transformation process. Creating new companies is therefore crucial. Diversification of the local economies is also a critical precondition for sustainable growth of the entire region.

Solving the problems of city-companies will require that the Belarusian authorities increase financial assistance; hence the budget will face heavier burdens. However, this burden would grow even more steeply if reforms were delayed. Possible sources of financing for this assistance include issuing special bonds and funding by international financial institutions.

5. Conclusions and recommendations

The non-market orientation of industry in the USSR in general and the creation of fully self-sufficient enterprises (having closed production cycles without benefiting from the division of labor) led to the situation where about 10% of all enterprises (with more than 1000 employees) in Belarus can be considered city-companies. These companies face grave economic problems, and yet, play an important social role. Closing down even a small city-company is likely to lead to serious unemployment and to set back regional economic development. The restructuring experience of other CEE countries shows:

1. The need to achieve cost transparency and to identify core businesses;
2. The importance of separating productive from non-productive assets and of providing social services through the public sector;
3. The relevance of clear legislation that provides for money privatization and bankruptcy procedures;
4. The significance of a general market-institutional environment with equal "rules of the game" that create proper incentives for owners and investors.
5. The importance of limiting government intervention in micro-level details of restructuring (day-to-day management, choosing which units of an enterprise to keep and which to sell or close down, etc.).

If an enterprise in effect has permanent structural deficiencies, it will be closed down sooner or later. There should be no illusions about possibly attracting foreign investment into such an enterprise. Keeping such enterprises afloat with state resources, i.e. with the taxpayers' money, is not useful and does not make any sense in the long run.

To correct the current lack of potential investors, the government should initiate the following steps as soon as possible:

1. Liberalize the economic policy to improve the investment climate, and reduce many aspects of state regulation;
2. Revise the laws "About privatization" and "About bankruptcy";
3. Encourage an independent evaluation of assets;
4. Implement a deregulation policy, including support for SME development;
5. Deregulate national labor market and develop an appropriate social policy.

The process of city-company restructuring will be painful and complex. But the sooner this process starts, the more opportunities for generating economic growth and sustainable development will be maintained and created.